IN THE HIGH COURT OF JUDICATURE, ANDHRA PRADESH
AT HYDERABAD

(Special Original Jurisdiction)

TUESDAY, THE FOURTEENTH DAY OF DECEMBER
TWO THOUSAND AND FOUR

PRESENT

THE HON'BLE MR JUSTICE V.V.S.RAO

-

WRIT PETITION NO : 22502 of 1999

Between:

Merfin(India)Ltd., Lakdikapul, Hyderabad, Rep.by its Director
P.S.R.Nagabhushan Rao.

..... PETITIONER

AND

1 National Stock Exchange, Lower Parel, Mumbai.
2 National Securities Clearing Corporation Ltd., Lower Parel, Mumbai.
3 The Superintendent of Police (C & ST) Crime Investigation

Department,Lakidikapul,Hyderabad.
4 Director General of Police, CID, Hyderabad.
5 Inspector,Special Team, CID, Lakdikapul, Hyderabad.
6 Krebs Bio-Chemicals Ltd.,Unit No. 5& 6,First Floor, Topaz

Complex, Amrutha Hills, Punagutta, Hyderabad.
7 K.Sahadev Reddy, Flat No.416,Gyandeep

Towers, Musharambagh, Hyderabad.

.....RESPONDENTS

Petition under Article 226 of the constitution of India praying that in the circumstances stated in the Affidavit filed herein the High Court may be pleased to issue a writ of Mandamus or any other appropriate writ, direction or directions declaring the action of the respondents 1 & 2 in treating the sale of Shares of the 6th respondent company made by the petitioner in certificates Nos.1196401-1199400, 1270001-1271900, 1287701-1287900, 1283601-1284900, 1284901-1287700, 1271901-1272100,1278901-1279500,1119801-1120900 as bad delivery as arbitrary, illegal and unconstitutional and to issue a consequential direction to the respondent No. 6 of effect the transfer of shares in respect of the above mentioned shares without treating them as bad delivery.

Counsel for the Petitioner: MR.Vedula Srinivas

Counsel for the Respondent Nos.1 and 2.: MR. Y.Ratnakar, Advocate for P.Murali Krishna, Advocate

Counsel for the Respondent Nos.3 to 5 : The G.P. for Home

Counsel for the Respondent Nos.6 and 7 : None appeared

The Court made the following :

THE HON'BLE SRI JUSTICE V.V.S.RAO

WRIT PETITION NO.22502 OF 1999

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ORDER:

Introduction

The petitioner, M/s.Merfin (India) Limited, is a company engaged in the business of selling and buying shares on the National Stock Exchange (NSE), the first respondent herein. The petitioner is also a registered stock broker/member of NSE. The present writ petition is filed seeking a writ of mandamus declaring the action of the NSE and National Securities Clearing Corporation Limited (NSCCL), the second respondent herein, in treating the sale of shares of the sixth respondent company effected by the petitioner in relation to shares covered by certificate Nos.1196401-1199400, 1270001-1271900, 1287701-1287900, 1283601-1284900, 1284901-

1287700, 1271901-1272100, 1278901-1279500 and 1119801-1120900 as bad delivery, as arbitrary, illegal and unconstitutional and for a consequential direction to the sixth respondent to effect the transfer of above mentioned shares without treating them as bad delivery.

Background Facts : Pleadings

The Managing Director of sixth respondent, one Dr.R.T.Ravi, is the owner of twenty thousand shares of sixth respondent company. He executed general power of attorney in favour of one Sri K.Sahadev Reddy, seventh respondent herein, who is also the Managing Director of another company, M/s.Shakti Sai Leafin India Limited. Under the general power of attorney, the seventh respondent was authorized to sell the stock of Managing Director of the sixth respondent. In pursuance thereof, seventh respondent entered into agreement of transfer of twenty thousand shares in favour of one Prithvi Raj and signed transfer deeds authorising in his favour. Mr.Prithvi Raj, in turn sold 11,100 shares to the petitioner at a price of Rs.11,00,000/- (Rupees eleven lakhs only) and that the amount was paid by the petitioner by way of cheque. The petitioner, in turn sold the shares to other third parties, who agreed for change of share transfer forms in their favour.

At that stage, the Managing Director of sixth respondent got filed a complaint with fifth respondent alleging that somebody took shares from him without paying consideration. Sixth respondent, having regard to the police enquiry, rejected transfer of shares lodged by the purchasers of the stock of the sixth respondent company. Since the shares are not transferred in favour of the buyers on the ground of pending police enquiry, NSE and NSCCL treated the shares “as bad delivery”. The consequence of treating the shares traded on NSE as bad delivery is that NSE would conduct auction for buying shares of sixth respondent and would deliver to the buyers, who lodged share transfer forms and the money so spent for buying valid shares, would be debited to the account of stock broker of NSE who introduced shares in the market. The NSE conducted auction for few lots, at which stage, the petitioner approached this Court by filing the writ petition. The Court while admitting the writ petition on 29.10.1999 passed interim orders in W.P.M.P.No.28203 of 1999 directing NSE and NSCCL not to conduct auction for shares for a period of three weeks. The interim order was later extended until further orders on 02.02.2000.

A common counter affidavit is filed on behalf of respondents 1 and 2 by the Senior Executive Officer of Legal Department of NSE. The averments in the counter affidavit, in brief, are as follows. The petitioner is as trading member of NSE sold shares of the sixth respondent company listed on NSE and delivered the same to NSCCL. Having received the consideration, the petitioner should have discharged its obligation of delivering valid shares, which are capable of getting transferred in the name of the petitioner. These shares were delivered to the buying trading member, who duly effected payment for the shares to NSCCL, who in turn was paid to the petitioner. When the petitioner sold the shares, he delivered the shares for the first time on NSE and therefore, “introducing member in NSE”. Subsequently, the same set of shares had changed several hands since the shares were bought/sold by various investors. When the ultimate investors, having purchased the shares for a

valid consideration, lodged share transfer forms with sixth respondent seeking transfer of the shares in their favour, said company refused to transfer the shares. NSE has provided redressal mechanism to the purchaser of the shares, which is in accordance with the norms prescribed by Securities and Exchange Board of India (SEBI). These norms are adopted by NSE. Whenever a company refuses to transfer the shares in favour of the purchaser, such transferee can lodge the shares through the receiving member with the NSE against the introducing member for rectification or replacement. If the introducing member fails to do the needful, the same has to be closed out either through auction mechanism or square off mechanism. It shall be the duty of the introducing member to rectify or replace the tainted shares with fresh shares, which are capable of being transferred in the name of transferee. The petitioner failed to discharge his obligation of delivering transferable shares in favour of the purchaser and with a *mala fide* intention approached this Court. Though NSE is amenable to writ jurisdiction of this Court, the petitioner is not entitled for any relief because the petitioner failed to avail the arbitration mechanism provided by NSE. The petitioner also filed two suits being O.S.Nos.4 and 102 of 1998 in the City Civil Court, Vijayawada for injunction restraining NSE from debiting any amount pursuant to auction conducted in respect of shares of Satyam Computers and Colgate-Palmolive. The petitioner being a trading member of NSE is bound by Bye-laws, Rules and Regulations of NSE and has to comply with all operational parameters, rulings, guidelines and instructions. The petitioner failed to comply with the rules and regulations and therefore the writ petition is liable to be dismissed.

Submissions of the learned counsel

The learned counsel for the petitioner, Sri Vedula Srinivas, submits that NSE cannot treat the shares of the sixth respondent introduced by the petitioner as “bad delivery” as the shares purchased by the petitioner company from the seventh respondent, (GPA of MD of sixth respondent), and Sri Prithvi Raj, are valid and genuine. The said shares do not fall under any categories of “bad delivery”. He also submits that when NSE issued letter dated 02.11.2001 suspending trading in equity shares by the sixth respondent, the same was challenged before this Court in W.P.No.23317 of 2001, that NSE filed a counter justifying their action and made categorical statement that the shares in question are not bad delivery and they were properly purchased and introduced in the market. Further he would urge that in the counter affidavit filed by NSE in the said writ petition, it was admitted that sixth respondent could not have refused to transfer the shares by brining the alleged misunderstanding/ disagreement of the transferor with the third party and that the action of the petitioner in purchasing the shares from the GPA/representative of MD of sixth respondent was justified. Placing reliance on the guidelines issued by NSE pursuant to Regulation 7.1 of NSCCL Capital Market Regulations regarding good/bad delivery norms, learned counsel would submit that in the absence of the criteria for treating documents as bad delivery in relation to missing/lost/stolen shares, it is not competent for respondents 1 and 2, or sixth respondent to treat the shares as bad delivery and initiate action for close out by auction/square off. He would further urge that the remedy of arbitration is available only to a purchaser or a constituent when the shares are not transferred on the ground that it is bad delivery and the remedy is

not available to a trading member.

Learned counsel for NSE and NSCCL, Sri P.Murali Krishna, opposing the writ petition argued as follows. The petitioner being a trading member of NSE is bound by NSE Rules, NSE (Capital Market) Trading Regulations, 1994 (the Regulations, for brevity), NSE Bye-laws and various guidelines issued under the Rules, Bye-laws and Regulations. These provide for an effective alternative redressal mechanism and without availing these, the petitioner cannot be permitted to stall the entire proceedings where large number of investors are involved. The petitioner being introducing member is not entitled to seek relief when the NSE and NSCCL initiated action in accordance with its regulations. When bad delivery is reported, introducing member is responsible and when such member fails to rectify the defects or fails to make payment, it is within the powers of NSE to conduct auction to give redressal to the investors, who ultimately purchase the shares. He would vehemently contend that the averments made on behalf of NSE have no relevance as the case filed by sixth respondent before this Court pertained to the suspension of listing agreement and the sixth respondent failed to transfer the shares as per Clause 12 of Listing Agreement.

Point for consideration

The only point that arises for consideration, in the facts and circumstances of the case, is whether the respondents 1 and 2 were not correct in resorting to the mechanism of “closing out by auction in the matter of 11,100 shares of sixth respondent purchased by the petitioner from the GPA/representative of MD of sixth respondent?

Finding

National Stock Exchange is a company registered under the Companies Act, 1956 discharging an important public function of facilitating smooth trading in shares and securities. The second respondent is a subsidiary of the NSE mainly dealing with securities clearance in hustle free manner. There is no denial that respondents 1 and 2 being “other authorities” and also discharging public functions, are amenable to the jurisdiction of this Court under Article 226 of the Constitution of India. Therefore, any action of the respondents 1 and 2 has to satisfy the tests of reasonableness and test of legality. If any action by NSE fails to satisfy these tests, such action must meet invalidation. While subjecting a decision of respondents 1 and 2 to judicial review, the NSCCL Capital Market Regulations, NSE Rules, NSE Bye-laws and the guidelines and NSE (Capital Market) Trading Regulations as well as guidelines for good/bad delivery framed by first respondent have to be referred to.

Stock Exchange is a place where persons so authorised, like members (stock brokers) or their agents buy and sell shares and securities either for themselves or on behalf of other persons. In the capital market, the scope for fraud and cheating is enormous. Therefore over a period of time a very complicated regulatory mechanism has been evolved by trial and error method, which ultimately came to be regulated

by legislature as well as the self-regulating regime of stock exchange itself. Every stock exchange has its own rules and regulations regarding the rights and privileges of its members, regarding the method and manner of dealing in shares and securities and method of settlement of transactions in capital market. These regulations also deal with stock broking members, who are in default either by not paying the amount for the shares purchased or for not delivering the shares sold. Though there may exist minor variations, by and large the procedure in all the stock exchanges in India – as at present the two active stock exchanges, i.e. NSE and Bombay Stock Exchange – is the same. These aspects in so far as NSE are concerned by the Rules, Regulations, Bye-laws etc.,

As per Capital Market Regulations, a trading member means an entity as defined in Chapter V of Bye-laws of NSE. Chapter V of
Bye-laws deals with trading members and empowers relevant authority to admit trading members in accordance with the bye-laws, rules and regulations subject to such member paying the fees and giving deposit. As per the bye-laws, a trading member (bye-law 2(a)) shall adhere to bye-laws, rules and regulations of the exchange and shall comply with operational parameters and guidelines of the authority as are applicable. Further a trading member (bye-law 2 (a) & (b)) is alone recognised as a party to any deal and every trading member is liable to every other trading member. The trading is carried on in accordance with the trading principles contained in Regulation 4.5.3 of Part A of Capital Market Regulations. When a deal/trade is finalised between one trading member and another trading member, Part B of Capital Market Regulations of NSE comes into play. This deals with procedure for settlement in clearing the securities, the good/bad delivery of documents in relation to securities, dispute relating thereto and the consequences thereof. Chapter 10 of Part B of Capital Market Regulations deals with closing-out of contracts. Regulation 7.1 of Part B of NSCCL Capital Market Regulations reads as under.

7.1 Which documents good delivery

The documents specified in these and relevant Regulations or such other documents as the Executive Committee may from time to time specify in addition thereto or in modification or substitution thereof shall constitute good delivery when tendered in fulfilment of contracts to which these Regulations apply.

In the event of bad delivery, the NSE may close out and effect such closing-out in the following manner, as per Regulation 10.9 of Part B, which reads as under.

9. **Closing-out how effected**

Closing out shall be effected against the Member by the Exchange in any of the following manners:

1. by buying-in or selling-out against the Member through an auction initiated by the Exchange.

2. by declaring a closing-out at such prices as may be decided by the relevant authority.

3. by buying-in or selling-out against the Member during the same trading period in which the deals were made or at any time thereafter.

4. in any other manner as the relevant authority may decide from time to time.

In the present case, respondents 1 and 2 initiated action against the petitioner, as the shares introduced by the petitioner in the market were not transferred in favour of the ultimate purchasers by sixth respondent. This is explained in the counter affidavit as under.

> The ultimate investor who had received the said shares, which were introduced by the petitioner, had lodged the same with the company for transferring the same into his name. But the company, Respondent No.6, refused to transfer the shares (copy of the letter issued by the Respondent No.6 is enclosed and marked as Annexure –R2). It is submitted that the ultimate investor had procured the shares through his broker (receiving member) being a Trading Member of Respondent No.1 and had paid valid consideration for the same through the Receiving Member. But the said consideration is only against delivery of such shares. Since the shares were not transferred by the company into the name of the transferee (being the purchaser), the purchaser had been provided sufficient redressal mechanism by the Respondent No.1 Exchange. The said redressal mechanism is also in accordance with the norms prescribed by SEBI for all stock exchanges in India and the same are adopted by all stock exchanges uniformly. As per the norms prescribed by SEBI and adopted by Respondent No.1, Muntandis Mutandis, whenever a company refuses to transfer the shares lodged with it into the name of the transferee/purchaser the purchaser through the receiving member can lodge the same against the Introducing Member for rectification or replacement. If the Introducing Member fails to do so then the same would be closed out either through auction or square off mechanism.
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> When the shares are lodged by the Receiving Member on the Introducing Member for rectification/replacement, it is obligatory on the part of the Introducing Member to rectify/replace the tainted shares with fresh shares which are capable of being transferred in the name of the transferee.

As the petitioner failed to comply with requirement of replacing the bad delivery shares, respondents 1 and 2 initiated action as per Regulation 10.9 of Capital Market Regulations. Whether this has been done property in a legal and reasonable manner is the question before this Court.

Regulation 7.1 of Part B of NSCCL Capital Market Regulations empowers the executive committee of NSE to specify the documents which constitute good

delivery when tendered in fulfillment of contracts in securities. In pursuance of Regulation 7.1 of NSCCL Capital Market Regulations, the guidelines for good/bad delivery have been notified. These guidelines give the description of good/bad delivery documents in relation to (i) transfer deeds (ii) share certificates and (iii) miscellaneous categories. In so far as bad delivery alleged is concerned, nothing is pointed out from the guidelines in relation to transfer deeds and share certificates either in the counter affidavit or across the Bar. As rightly pointed by the learned counsel for the petitioner, this situation under the heading 'Miscellaneous' have to be looked into. Serial 109 thereof reads as under.

> 109. For reporting missing/lost/stolen shares as objection the following documents are required:
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> A. If they are returned as objection from the company due to above reason:
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> - company objection memo stating that the shares are missing/lost/stolen accompanied by a copy of Court Order or FIR or copy of acknowledged police complaint
>
> - copies of both sides of the transfer deeds
>
> - copies of both sides of the share certificates
>
> B. Otherwise one of the following documents are required:
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> - public notice given by the company/register
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> - notification from any stock exchange
>
> - letter of intimation from the company to stock exchange.
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> Clarifications:
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> 1. In cases where duplicate shares have been issued to a third party under the provisions of Section 108(1) A of the Companies Act, the company should also provide the name and address of the third party to whom the duplicate shares have been issued along with the date of request for duplicate shares by the third party.
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> 2. In cases where the companies have issued duplicate certificates for missing/lost/stolen shares, the receiving member is not required to submit FIR/court order copies, which reporting company objections.

A plain reading of the above guideline would show that when shares are missing/lost/stolen, an objection can be lodged with NSE duly enclosing the documents like copy of the Court order or first information report lodged with the police station or copy of the acknowledged police complaint, copies of both sides of the transfer deeds etc. Merely because, the Managing Director of sixth respondent lodged a complaint with fifth respondent, the same does not render documents a bad delivery. It is not denied before this Court that no complaint is given by the sixth respondent to the police station or a Court order was never lodged except a letter of

the sixth respondent refusing to transfer the shares in favour of the ultimate purchasers. Therefore, the action of the respondents 1 and 2 in resorting to closing out procedure under Regulation No.10.9 is *ex facie* illegal and cannot be sustained. Needless to say, that, if a decision maker does not appreciate facts and applies wrong law, it is a case of illegality, which must be visited with invalidation.

There is sufficient material before this Court to draw inference that though respondents 1 and 2 initially treated the shares introduced by the petitioner as bad delivery and initiated action under Regulation 10.9 of NSCCL Capital Market Regulations, it appears the respondents 1 and 2 themselves realised the mistake and initiated action against the sixth respondent as per the listing agreement with sixth respondent with NSE. Pending such action by letter dated 02.11.2001 suspended the trading in equity shares of sixth respondent with effect from 19.11.2001. The sixth respondent filed the writ petition being W.P.No.23317 of 2001 seeking a writ of certiorari to quash the letter of NSE on various grounds. The Assistant Manager in the legal department of NSE, Mumbai, filed a counter affidavit on its behalf. In the said counter, NSE stated that sixth respondent addressed a letter on 20.04.2001, explaining that fraud has been played by third party in whose favour power of attorney was executed and therefore sixth respondent refused to register the transfer. While asserting that as per Clause 12 of Listing Agreement, the sixth respondent cannot refuse to register the shares. It was further stated as under.

> … the contract for the sale/purchase of securities is concluded through the computerized trading system and the trade confirmation is obtained by the buyer and the seller simultaneously. The purchaser of the shares is under an obligation to make the payment and the seller is under an obligation to deliver the shares through the clearing mechanism. In the instant case, the third party in whose favour the Power of Attorney was executed by the Managing Director of the Petitioner Company for the shares owned by him in the Petitioner Company had sold the shares through the Exchange and the payment was made for such shares. The bonafide purchaser who had received these shares lodged the same for the purpose of transfer with the Petitioner Company. At this juncture, the Petitioner Company refused to transfer the shares on the ground that fraud had been perpetrated by his agent in whose favour the Power of Attorney was executed. The profound fact is that the shares were duly signed and delivered by the third party in whose favour a valid Power of Attorney was executed by the Managing Director of the Petitioner Company and the grounds on which the transfer was rejected is contrary to the specific provisions of the Listing Agreement. The conduct of the company by rejecting the transfer of shares on the ground that the Power of Attorney holder played fraud has lead to the present situation wherein the bonafide investors paid the consideration for the shares but have not been bale to secure the registration of the shares in their favour till date. Several investors have been complaining to the Respondent Exchange and it is under these circumstances the Respondent Exchange had to enforce the provisions of the Listing Agreement and decided to suspend the trading by its letter dated 2nd November, 2001 after complying with all the requirements.

This Court in its judgment dated 15.04.2003 in the above writ petition after referring to Clause 12 of the Listing Agreement and the provisions of Securities Contracts (Regulation) Act, 1956 dismissed the writ petition observing as under.

> On a combined reading of the above provisions of the Act and Rules it is clear that the principal object of listing is to provide liquidity and marketability to the listed securities and to ensure effective monitoring of trading for the benefit of all the participants in the market. There can be no doubt that the Company executing such Listing Agreement is bound by the terms and conditions of the agreement.
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> … In the instant case as can be seen from the material on record the Managing Director of the petitioner-Company issued a Power of Attorney in favour of a third party, pursuant to an alleged financial understanding between the Company and the third party. The petitioner-Company registered the Power of Attorney executed in favour of the third party and certified the same on the back of the transfer deed. The shares were sold in the market and the share certificates together with such valid transfer deeds were delivered as per the requirements of the respondent-Stock Exchange. The investors who are bona fide purchasers in the market lodged the shares for the purpose of transfer with the petitioner-Company. The petitioner-Company refused to transfer the shares on the ground that fraud has been played by his Agent in whose favour the Power of Attorney was executed. However, the fact remains that the shares were duly signed and delivered by the third party in whose favour a valid Power of Attorney was executed by the Managing Director of the petitioner-Company.

A perusal of the counter affidavit of the first respondent in W.P.No.23317 of 2001 as well as the judgment of this Court in the said writ petition would show that the sixth respondent committed grave irregularity and illegality in refusing to register the shares in favour of the ultimate purchasers and in such a situation none of the guidelines issued pursuant to Regulation 7.1 of Capital Market Regulations would be attracted. The entire action initiated by the respondents 1 and 2 against the petitioner suffers from misdirection in law and grave error apparent on the face of record. Accordingly, the writ petition succeeds. A Writ of Mandamus shall issue as prayed for. In the peculiar circumstances of the case, this Court, however, makes no order as to costs.

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(V.V.S.RAO,J)

14.12.2004.

pln

That Rule nisi has been made absolute as above.

Witness the Hon'ble Sri Devinder Gupta, the Chief Justice on this Tuesday, the Fourteenth day of December, two thousand and four.

To

1. The National Stock Exchange, Lower Parel, Mumbai.
2. The National Securities Clearing Corporation Limited, Lower Parel, Mumbai.
3. The Superintendent of Police (C&ST), Crime Investigation Department, Lakdikapul, Hyderabad.
4. The Director General of Police, CID, Lakdikapul, Hyderabad.
5. The Inspector, Special Team, CID, Lakdikapul, Hyderabad.
6. 2 CCs to the Government Pleader for Home, High Court of A.P., Hyderabad (OUT).
7. 2 CD copies.